

DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS NUMBER: 95-0265 IT
Gross Income Tax — Receipts Received by Agents
Tax Administration — Negligence Penalty
For Tax Periods: 1991 Through 1993

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ISSUES

I. Gross Income Tax — Receipts in an Agency Capacity

Authority: IC 6-2.1-1-2(a), IC 6-2.1-1-10, IC 6-2.1-1-11, 45 IAC 1-1-54

Universal Group Limited v. Indiana Department of Revenue, 609 N.E.2d 48 (Ind. Tax 1993)

Universal Group Limited v. Indiana Department of Revenue, 642 N.E.2d 553 (Ind. Tax 1994)

Taxpayer protests the proposed assessment of gross income tax on reimbursements for wages, employment taxes, and other employment benefits that it advanced to certain employees.

II. Tax Administration—Penalty

Authority: IC 6-8-10-2.1, 45 IAC 15-11-2, 45 IAC 2.2-3-20

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is incorporated and domiciled in Indiana. Taxpayer, a lessor of buildings and office spaces, operates under five divisions (four during the audit period). Taxpayer provides payroll and centralized management services for its internal divisions. Additionally, taxpayer provides similar services for several non-affiliated entities (entities) which maintain similar ownership. For providing these payroll services, taxpayer is reimbursed for costs incurred. At issue is the characterization of these reimbursements for payroll services provided by the taxpayer to the non-affiliated entities.

I. Gross Income Tax – Receipts in an Agency Capacity

DISCUSSION

The taxpayer and the non-affiliated entities operate out of a common office. To avoid the duplication of personnel and support services, taxpayer processes all payrolls and pays all salaries. Taxpayer is then reimbursed for its expenses.

In dispute is taxpayer's exclusion of these reimbursements from its taxable gross income. Taxpayer reasons that because an "agency relationship" existed between itself, as agent, and the entities, as principals, the reimbursements for payroll expenses were properly characterized as *the receipts received by an agent*. Accordingly, the taxpayer believes that the exclusion of these receipts from its taxable gross income was proper. The auditor has disagreed and has re-characterized the reimbursements as service receipts, which are taxable at the higher rate.

Indiana's Gross Income Tax encompasses most receipts of income. Pursuant to IC 6-2.1-2-2(a), "[a]n income tax, known as the gross income tax, is imposed upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana..." Except as expressly provided in IC 6-2.1 et. seq., gross income means all the gross receipts a taxpayer receives. According to IC 6-2.1-1-10 et. seq., *the term receipts refers to the gross income received by the taxpayer or a third party for the taxpayer's benefit*. Gross income can be received in many ways. A taxpayer can receive gross income upon the actual coming into possession of, or the crediting to, the taxpayer, of gross income or [upon] the payment of a taxpayer's expenses, debts, or other obligations by a third party for the taxpayer's direct benefit. See IC 6-2.1-1-11.

But there are some exceptions. Taxpayers are not subject to Indiana's gross income tax on the income they receive in an agency capacity. In *Universal Group v. Indiana Department of Revenue*, 609 N.E. 2d 48 (Ind. Tax 1993), (*UGL I*), the Indiana Tax Court explained that "reimbursements of a *taxpayer's own expenses* are receipts of gross income to the taxpayer... [while] [c]onversely, reimbursements to an agent for amounts *advanced or paid to third parties* substantively represent 'pass throughs' of income and [therefore] are not taxable to the agent. *UGL I* at 54.

The existence of an agency relationship alone, however, does not automatically lead to the characterization of reimbursements as pass through income. For reimbursements to be exempt from inclusion in taxpayer's taxable gross income, there must exist both an agency relationship and a pass through of income. As the preamble to 45 IAC 1-1-54 explains, "[t]axpayers are not subject to gross income tax on [the] income they receive in an agency capacity. *However, before a taxpayer may deduct such income in computing his taxable gross receipts, he must meet two (2)*

requirements.” (Emphasis added).

45 IAC 1-1-54 continues, in part:

(1) *The taxpayer must be a true agent.* Agency is a relationship which results from the manifestation of consent by one person to another authorizing the other to act on his behalf and subject to his control, and consent by the other to so act. Agency may be established by oral or written contract, or may be implied from the conduct of the parties. However, the representation of one party that he is an agent of another without a manifestation of consent by the alleged principal is insufficient to establish agency. Both parties must intend to act in such a relationship.

Characteristic of agency is the principal’s right to control the acts of the agent throughout the entire performance of the contract. This right to control cannot be limited to the accomplishment of a desired result. In addition, the principal must be liable for the authorized acts of the agent.

(2) The agent must have no right, title, or interest in the money or property received or transferred as an agent. In other words, *the income received for work done or services performed on behalf of a principal must pass intact to the principal or a third party; the agent is merely a conduit through which the funds pass.* (Emphasis added).

Taxpayer contends that its position is best supported by *Indiana Department of State Revenue v. Marsh Supermarkets, Inc.*, 412 N.E.2d 261 (Ind.App. 1980). In *Marsh Supermarkets*, the parent corporation contractually agreed to act as agent for its wholly owned subsidiaries in performing unspecified personnel functions. The subsidiaries, in turn, reimbursed the parent for its expenses. The court held that the payments from the subsidiaries to their parent represented reimbursements for the parent’s costs and were therefore, not subject to inclusion in parent’s taxable gross income. Taxpayer, in this instance, believes that its situation is analogous to that of the parent in *Marsh Supermarkets*, and consequently, the results should be the same.

Taxpayer’s reliance on *Marsh Supermarkets*, alone, is not sufficient. In *Marsh Supermarkets*, the taxpayer’s agency status was not contested. The issue there was whether the reimbursements paid to the parent (agent) accurately reflected the parent’s expenses. But more importantly, “[n]owhere in *Marsh* ... did the court of appeals explicitly analyze the beneficial interest in the reimbursements, that is, whether the reimbursements were for advances or payments to third parties, thus substantively representing ‘pass throughs’ of income.” See *Universal Group Limited v. Indiana Department of State Revenue*, 642 N.E.2d 553, 556 (Ind. Tax 1994) (*UGL III*).

The limits of *Marsh Supermarket* were identified when the court in *UGL III* went on to explain that “[i]f the reimbursements to the parent simply constituted reimbursement of the parent’s own expenses, [then] *Marsh* is an inaccurate statement of the law ... If, on the other hand, the reimbursements were substantive ‘pass throughs’ to reimburse the parent for [the] payments it made to third parties on behalf of [its] subsidiaries, *Marsh* is correct.” *UGL III* at 556. For our purposes, taxpayer’s reliance on *Marsh Supermarket*, without more, cannot be conclusive because the nature of the reimbursements was never determined.

Regardless of the weight and relevance given to taxpayer’s case authorities, taxpayer can still meet the two requirements of 45 IAC 1-1-54 by showing that (1) an agency relationship existed, and (2) the taxpayer, as agent, did not have a beneficial interest in the income received.

The taxpayer, in its letter of protest, stated that a true agency relationship did in fact exist. Taxpayer explained that the agency relationship, along with the necessary manifestation of consent, was created by oral agreement. In a supplemental affidavit, taxpayer also offered evidence to support its contention that the entities (principal) had exercised the requisite control over taxpayer’s (agent) actions. Taxpayer explained:

The employees in question in this case are hired and fired as employees of the respective entity for which they perform their duties. The management and/or owner of each entity controls where the employees work, how they perform their duties, and when they perform the work.

While taxpayer has described how the entities may have had day-to-day control over the *employees’* work assignments, taxpayer has failed to show how the entities actually controlled the *taxpayer* in its performance of activities that were within the scope of the agency agreement – i.e., the processing of payroll.

Even assuming taxpayer had established the existence of an agency relationship, the ultimate question still remains whether or not the reimbursement transactions represented “pass throughs” of income. The money received by the taxpayer, money characterized as reimbursements for payroll expenses, was used to pay *the taxpayer’s own employees’ wages and benefits*. The employees, although working primarily for the entities, were those of the taxpayer. Taxpayer was responsible for paying the employees’ wages, withholding taxes, and for making the employees’ insurance payments. In taxpayer’s own words:

“[Taxpayer] provides, on the required quarterly basis, the documentation and payment to the Indiana Department of Workforce Development *for payment of the required taxes for all the employees for all the businesses involved.*” (Emphasis added.)

The Indiana Department of Workforce Development Quarterly Contribution Report (Form UC-1, SF 250) indicates that the account was in taxpayer's name. So as the employer of record, taxpayer's interest in the "reimbursements" was more than incidental.

Taxpayer counters in its letter of protest by stating, "[t]he fact that the individuals were given a Form W-2 from [taxpayer] does not mean that a true agency relationship does not exist." Taxpayer is correct. Those facts, by themselves, would not negate an inference that an agency relationship existed. However, the fact that Form W-2 was issued by the taxpayer does indicate that the reimbursements in question did not pass through to third parties. They were retained by taxpayer to pay its own employees' wages and benefits. The taxpayer, necessarily, had a full beneficial interest in the income received.

Because taxpayer retained the reimbursements and used the money it received to pay its own employees, the taxpayer was not acting simply as a conduit through which the money passed. The Department, therefore, must conclude that the receipts received by the taxpayer for the reimbursement of payroll services rendered must be included in taxpayer's taxable gross income.

FINDING

The taxpayer's protest is denied.

II. Tax Administration — Negligence Penalty

DISCUSSION

The taxpayer protests the imposition of the ten-percent (10%) penalty. The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

In this case, the Department is satisfied that the taxpayer has made a reasonable interpretation of the statute and case law. Although the taxpayer failed to properly characterize the reimbursements of its payroll expenses as taxable gross income, the Department believes the taxpayer did exercise ordinary business care and consequently, acted in good faith. Additionally, this issue has not surfaced in previous audits. For all these reasons, the Department believes that the negligence penalty should be waived.

FINDING

The taxpayer's protest is sustained.